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Not Even 2% Fed Funds Help Munis Amid Record Rates

By William Selway and Martin Z. Braun

Aug. 7 (Bloomberg) — The Oakland, California, agency that runs toll bridges across the San Francisco Bay is proving that the era of cheap money for municipal borrowers is over.

This week the Bay Area Toll Authority sold more than $700 million of bonds at rates as high as 5.33 percent to refinance debt that cost 4 percent last year. That leaves less money to finance projects, such as bridge improvements.

"The cost of money just went way up," said Brian Mayhew, the agency's chief financial officer. "You may have projects on the cusp that are going to be difficult to do."

Almost a year after the Federal Reserve began to cut its target rate for overnight loans between banks to 2 percent from 5.25 percent, borrowing costs for states, cities, hospitals and municipal authorities are going in the opposite direction.

The $2.66 trillion municipal debt market is reeling from a series of jolts springing from a decline in the creditworthiness of insurers that once backed half of all securities sold at the same time the economy teeters on the edge of a recession, eroding tax revenue. Bond prices have fallen an annualized 4.75 percent so far this year, the most since tumbling 11.3 percent in 1999, Merrill Lynch & Co.'s Municipal Master Index shows.

"The world is falling apart" for borrowers, said Robert Doty, the president of American Governmental Financial Services, an advisory firm in Sacramento.

Relative Yields

Top-rated tax-exempt bonds due in 10 years have yielded an average of about 99 percent of Treasuries with similar maturities this year, and reached a record of 115 percent in February, according to Concord, Massachusetts-based research firm Municipal Market Advisors. Because of their tax benefits, municipal debt typically yields about 87 percent of Treasuries.

Spread over the $330 billion of fixed-rate municipal debt that JPMorgan Chase & Co. estimates will be sold this year, that translates to as much as $1.6 billion in extra interest costs annually over the historical average.

"The unwinding of the credit bubble has had dramatic implications," George Friedlander, a municipal strategist at Citigroup Inc. in New York who has covered the market for more than 30 years, said in an Aug. 1 report.

Not Good

Washington D.C.'s interest costs on some floating-rate bonds rose to as high as 15 percent this year, adding $4 million to its debt expense, said Lasana Mack, deputy chief financial officer.

"We recognized that some unprecedented things had occurred in the market, but of course it doesn't feel good to pay 15 percent," Mack said. The district converted about $800 million of auction-rate securities and other floating-rate bonds into variable debt with stronger backing from banks, and plans to convert another $125 million.

The College of Santa Fe in New Mexico is stuck with debt that's threatening to consume a larger share of its $27 million budget. The rate on a $25 million bond sold by the college is now at 10 percent, more than double a year ago. The college has been unable to persuade a bank to put up a letter

of credit that would guarantee the bonds from default and help lower rates, said David Rivard, the school's vice president of finance.

"Nothing has stabilized, and rates have just been going up," Rivard said.

Spending Cuts

That's not what Fed Chairman Ben S. Bernanke had in mind when he starting slashing the Fed's target rate in September as the credit market seized up. Instead, the economy continued to worsen, eroding tax revenue.

During the first three months of 2008, tax revenue climbed at the slowest pace since 2003 as sales-tax collections fell for the first time in six years, according to the Nelson A. Rockefeller Institute of Government in Albany, New York.

The National Conference of State Legislatures in Washington described the plight of municipal finances in a July report.

The state lawmakers group found that states are cutting spending on schools and health care, tapping reserves and borrowing to close $40 billion of budget gaps. New York, Virginia and eight other states trimmed spending across the board for the budget year that began in July for all but four states. Seven of the 31 states with fiscal 2009 deficits raised taxes.

Airport Refinances

When the rate on bonds issued by San Francisco International Airport and insured by Syncora Guarantee Inc., formerly XL Capital Assurance, and Financial Guaranty Insurance Co., both of New York, rose as high as 9 percent this year, airport officials decided to convert the debt to new securities guaranteed by insurers that hadn't lost their AAA ratings.

The benefits proved temporary. Moody's Investors Service on July 21 said that the ratings for those companies, New York-based Financial Security Assurance Inc. and Assured Guaranty Ltd. in Bermuda, may be reduced as well. The airport's borrowing costs jumped by about a percentage point, said Kevin Kone, who handles the airport's finances.

"This is the same cycle and profile and story the other guys went through before they lost their rating," Kone said of the insurers, adding that the airport may need to refinance again if the companies are stripped of their AAA ratings. "When this started happening last August, people thought the sky was falling and, knock on wood, we were able to get through it and repair all our debt. Maybe this time it may be more difficult because if you have no bond insurance, what's the market going to do?"

Insurance Drops

Municipal borrowers insured 14 percent of the bonds they sold in July, down from 47 percent during all of last year, based on preliminary data cited by Merrill.

In late June, the University of Alabama at Birmingham's University Hospital issued $110 million of fixed-rate bonds to refinance debt including auction-rate securities, whose interest costs had increased as high as 10 percent.

The university sold 10-year bonds without insurance and rated A+, the fifth-highest investment grade, to yield 5.1 percent, one percentage point higher than Treasuries with the same maturity.

States will likely increase bond sales to meet budget demands next year after already increasing short-term borrowing, Standard & Poor's said in a July 14 report.

The New York credit-rating company said discretionary resources that states often rely upon to fund capital projects have mostly evaporated, causing them to meet needs with bonds in fiscal 2009.

"There are still guys who will lend you money," said Mayhew of the Bay Area Toll Authority. "It will just cost more."